DOW THEORY LETTERS INC
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THE MARKET: In the last two Letters I drew attention to the mid-July peaks of 883.23 (Industrials) and 202.24 (Rails). "Consider the secondary trend bearish unless the July highs (883.23 and 202.24) are jointly bettered. If the July peaks are hurdled, we could get an important extension of the secondary upward correction."

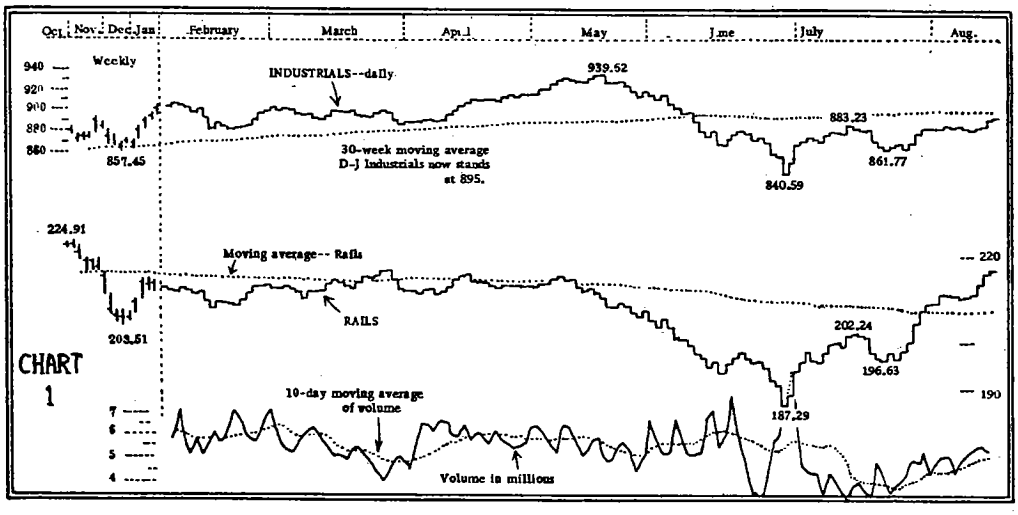
On July 29 Rails bettered their July peak, and on August 4 Industrials pushed fractionally above their own July high. A slight dip followed, but last Friday (August 13) Industrials gathered steam and pushed well above their own July peak. Volume has been tending to expand as the rise progresses. With the technical advantage of a record number of shorts (7.2 million) now "locked into" a market which has bettered previous peaks, we could witness an increase in speculative interest as the Industrial Average sets itself up for a potential try for the previous bull market high of 939.62.

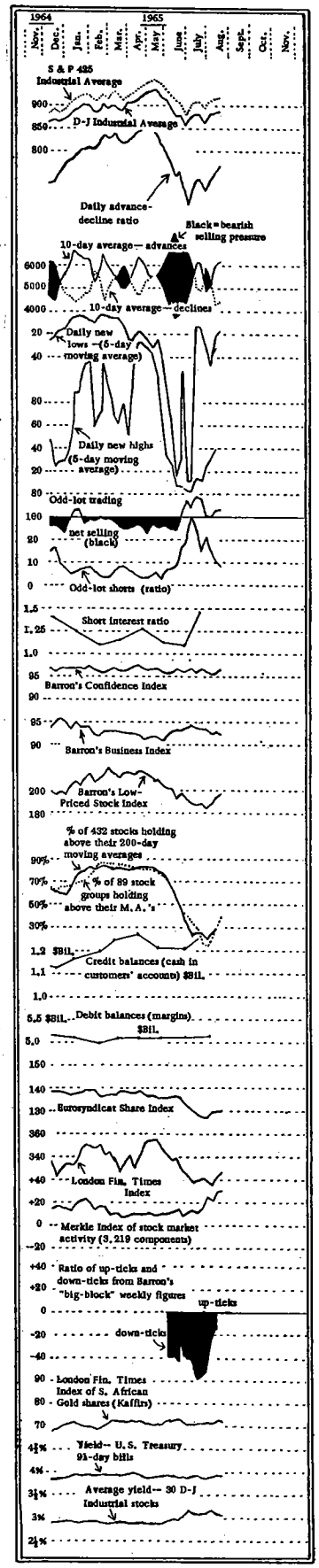
Monday's rise represented the 14th day of consecutive advancing breadth (advances over declines), and thus the market is rapidly becoming "over-bought." Signs of "big money" distribution during the rally are evident from (1) The declining trend of the D-J 40 Bond Index, now at its lowest level in a year. (2) The badly lagging Utility Average, up only 3% since the June low (see later section of this Letter). (3) The steady succession of big blocks on "down-ticks" (see Composite Chart). (4) The break in the Confidence Index (see Composite Chart) two weeks ago to its lowest level in over a year. None of these alone can say "finis" to the advance, but taken together they suggest that the market is putting itself in an increasingly dangerous position.

The 890 level was touched on Monday, August 16, and thus the attack on this first "target" has been successful. The importance of 890 is explained in a later point & figure section. The next target is the 896 level which is the current level of the 30-week moving average. I would guess that if Industrials can close and consolidate above 896, the odds are 50/50 that the bull market high of 939.62 will be approached or even bettered.

None of the above should be construed as an open recommendation to buy or even to speculate in the period ahead. I consider the market to be moving into increasingly dangerous territory. The next turn could come with even less warning than was the case during mid-May.

The Composite Chart (Page 1) shows the A-D ratio now pushing well above its July high with the D-J Industrial Average finally confirming last week. The 10-day total of advances is now in the "over-bought" position, having fully corrected the massive "over-sold" area of May-June. New highs continue to creep higher, but they are still less than half the 149 (5-day average) peak total recorded on April 19, 1965. Odd-lots have switched slightly to the buy side, while odd-lot shorts have contracted sharply (which is normal). Barron's Confidence Index now stands at 96.4, having broken its trading range of the past year two weeks ago when it sank to 95.7. The percentage of 432 stocks holding above their moving averages has risen to 39%, still bearish because it is below the critical 50% level. The new "big money" indicator, the ratio of big block up-ticks to down-ticks (from




1964
1965
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average— advances
10-day average— declines
Daily new lows —(5-day moving average)
Daily new highs (5-day moving average)
Odd-lot trading
net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 432 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield-- U.S. Treasury 91-day bills
Average yield-- 30 D-J Industrial stocks

Barron's 10,000 share block tabulations), will now be a permanent feature of this chart. As seen on the chart, the down-tick (bearish) ratios continue unabatedly (latest reading is minus 12), suggesting that big money has been distributing stocks throughout this rally. The Kaffir (S. African gold) index continues to reflect the world's monetary worries by holding within two points of its four year high. Conclusion: The indicators suggest that big money is selling, but such distribution cannot pinpoint a final top. Markets under distribution frequently form double or even triple tops. My suggestion to subscribers — follow the big money, continue to liquidate your securities.

WHERE TO WATCH: Point & Figure charts are often particularly helpful in that they tend to condense and therefore simplify market action. Only price movement appears on P & F charts, and this means that the time element is absent. Thus, for instance, it is possible for a series of violent price fluctuations to occur within a two-day period (and these would appear as many rows on a P & F chart), and then little or no movement might take place for six months (with the result that no entries would appear on the P & F chart for six months). P & F chartists believe that patterns are formed by action — not by time. Furthermore they believe that the movement creates the volume. Therefore, they see no purpose in plotting either volume or time measurements on P & F charts.

UTILITIES: There is one particularly interesting facet to this rise. Although the D-J Utility Average plays no part in orthodox Dow Theory, I have always felt that the Utility Average (much like the bond averages) reflects the thinking of "smart money."

It is interesting to note that after the 1957-58 reaction the Utilities were the first of the three Averages to recover. The Utility Average rose to a new bull market high during the week of April 12, 1958, a full five months ahead of the Industrials Average which did not record a new bull market high until the week of September 20, 1958.

During the 1960 reaction Utilities hardly budged, and on July 9, 1960, Utilities were already pushing to bull market highs even though the Industrials did not hit bottom until October, 1960. During the week of August 15, 1961, the Industrials rose to a new bull market high — having been preceded by the Utilities by a full thirteen months!

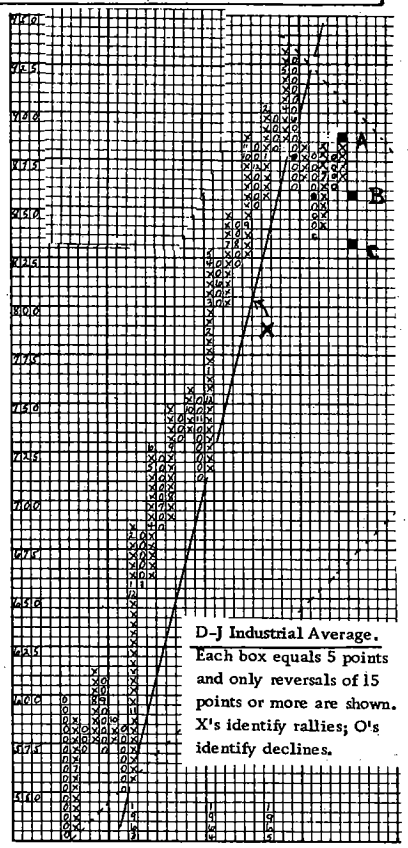
Following the 1962 crash, Utilities turned up and recorded a new bull market high on the week of February 9, 1963. Industrials did not touch a new bull high until the week of October 12, eight months later. Thus the Utilities have led the way to new bull market highs following every important decline of the last decade.

In view of this, it is interesting to witness the Utility Average now lagging badly. The June, 1965, low closing for the Utility Average was 150.12. As of last week the recovery in Utilities had taken them to the 155 area — a recovery of around 3%. Thus, Utilities are now acting differently than they acted during 1957-58, 1959-60 and 1962-63. Watch Utilities carefully from here on, they may be telling an important story.

Personally I feel that both bar charts and P & F charts are useful, and that one type of chart will often augment the other. I find that there are occasional advantages in the time measuring features of bar charts, and I also find that volume implications of bar charts can be helpful. However, P & F charts have two definite advantages over bar charts: (1) It is much easier to identify major tops and bottoms with P & F charts. Often, for instance, an extended major bottom will be obscured on a daily or even a weekly bar chart, but the pattern may show clearly and dramatically on a P & F chart. (2) It is usually easy to identify "buy" (bull) and "sell" (bear) points on a P & F chart. Such signals are obviously not always "perfect," but I find it advanta - geous to know that when a given stock touches a given point that stock has definitely turned bullish. Such a signal may be mechanical, but it is definite, and this is a great advantage.

The accompanying P & F chart of the D-J Industrial Average is a 5-point (15 point reversal) chart. This simply means that every box on the chart is equal to 5 points, and only changes in direction of 15 points or more are plotted on this chart. Thus, the chart shows the action of the Dow in a fairly condensed form. X's on the chart signify rallies, O's signify declines.

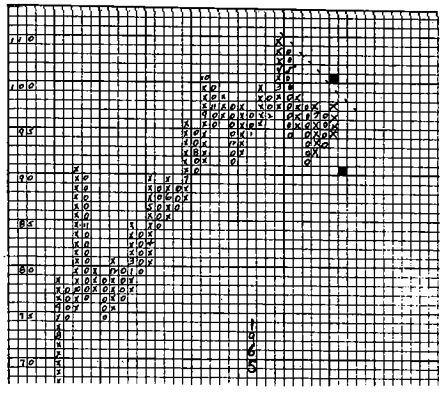
The first thing we note is that all the action in the Industrial Average is now occurring following a violation of the main rising trendline (marked X on chart). This suggests that the main momentum of the upthrust has been broken. Secondly we note that for the first time the P & F pattern is showing enough sideways movement to outline what could be part of a potential major top on the Dow. But is this a true top or merely a pause preparatory to the next rise? From a P & F standpoint, when the Dow declined to 880 (first black dot on chart) thereby breaking a preceding bottom, it gave a first sell signal. Then when the Dow dropped to 860 (second black dot) breaking a second preceding bottom, it gave a second sell signal. The resultant decline carried to 840 on the chart.



D-J Industrial Average. Each box equals 5 points and only reversals of 15 points or more are shown. X's identify rallies; O's identify declines.

At 11 A.M. on Monday (Aug. 16) the Industrials touched an hourly 890, which is shown by the black square marked A on chart. In so doing, the Industrials bettered two preceding peaks. Technically, this allows the Dow to move up to the (inhibiting) declining trendline at 910. If the Dow can better 910, it will be in a position technically to try for the previous high at 935. If it can better 935 the Dow will be completely bullish and in the clear. On the other hand, if the Dow should sink to 860 (black square B) thereby breaking a preceding bottom we would have a secondary bear signal. If the decline continued to 835 (black square C) we would have a reconfirmation of the bear trend and a probable major extension of the bear market.

GENERAL MOTORS (GM)



A second key area for scrutiny is General Motors, key stock in the key industry of the nation. For the first time since 1962, GM has formed a potential major top on a one-point (3-point reversal) chart. A preliminary bullish signal would come if GM touched 99, a more important signal would occur if GM bettered its declining trendline by touching 101 (top

black square). On the other hand, a decline to 91 (bottom black square) would be extremely bearish for GM. Such a move would break a previous "double bottom" and would provide a P & F "count" or projection into the low 70's for GM.

How is the "count" obtained. Note that the potential top in GM measures 17 boxes across. If the lower black box is touched at 91, GM will measure 18 boxes across. Since each box is equal to 1 point, a break to 91 would allow for an 18 point drop below the breakthrough level — to 73. In bear markets the downside movements often surpass the counts and the converse is true of upside breakouts during bull markets. (P & F charts courtesy of Chartcraft, Larchmont, New York).

GRIM STRUGGLE: As fall approaches, the eyes of the world focus on Britain and the battle of the pound. If the pound goes, it will mark the end of the sterling area and the pound's role as an internationally acceptable currency. It could ruin Britain, which needs giant long-term credits to keep her afloat. If the pound goes, it will immediately put pressure on the "sister reserve currency," the dollar. This latter fact is one of the reasons why the U. S. is vitally interested in propping up Britain.

But the facts are not pleasant. (1) The U. S. is in poor fiscal shape herself. With a long series of adverse balance-of-payments, a declining trend in exports, a policy of monetary inflation and an expanding war to fight, the dollar has its own serious troubles. (2) It is reported that L. B. J. is concerned lest we get in over our heads in supporting the pound. Such support could worsen the gold outflow, and could in the end simply mean more dollars down the drain. (3) It is estimated that support of the pound is costing the London Gold Pool $140 million a month in gold. Since the Gold Pool is half owned by the U. S., half the loss is ours. (4) The whole British financial structure is deteriorating. Instead of becoming more competitive in world markets, Britain is heading the other way. For instance, 41 (out of 42) major union contracts have been settled above the Government's 3 to 3½% "guideline." Britain's cost-of-living is sky-rocketing at an annual rate of 6.6%. Her wages, retail prices and export prices keep climbing. There is only one way out for Britain — politically unpalatable deflation. (5) The British portfolio of U. S. securities is being liquidated for the purpose of potential support of the pound. If the dollars obtained by these security sales are used for the pound's defense, the U. S. balance-of-payments is going to be hit hard. (6) A general contraction in European economies is intensifying the world export struggle. The winners in the struggle are likely to be the low cost, hard working nations like Japan (rather than Britain).

GOLD OPINIONS: People are normally optimistic, or, as Wall Street puts it, it is easier to be a bull than a bear. But what about being bullish on the gold shares? Perhaps once in a generation there is a "play" on devaluation. Aside from such rare periods, however, a bull on gold shares is generally as unpopular as a bear on the market. Reason — devaluation stems from monetary trouble, and monetary trouble is almost always bearish for the general market. In other words, the "normal pressure" is for an advisor or a brokerage house to either ignore or disapprove of gold shares. In view of this, what have leading services been saying about golds?

E. George Schaefer is not enthusiastic about gold, and last January he wrote as follows: "As I have said many times before, gold may be a partial answer — but certainly not the complete answer to the question of where to put money during the 'holding period' before we have a stock market decline and business contraction .... I would certainly not tie up more than a small percentage, maybe 10% to 20% in such an 'iffy' proposition as the gold stocks."

Joseph Granville was bullish on golds until around June. He then turned (correctly) short-term bullish on the market and disinterested to bearish on the golds.

Alden Wells has been one of the real bulls on gold. In his May, 1965, report, he shocked even the bulls on gold by writing as follows: "Most observers have felt that the present value of the dollar warrants a price of $70 per ounce of gold. My own observation of politicians in monetary difficulties in various countries has been that the solution is overdone. One hundred dollars per ounce seemed, therefore, probable. We now appear at the threshold of a major inflation. The ultimate price of gold in terms of dollars is incalculable — but $500 per ounce is not unreasonable."

James Dines is a leading proponent of the value of gold shares as a hedge in what he believes is a coming monetary crisis. In a recent Letter, Dines advocated increasing the gold segment of individual portfolios from 15% to 30%.

Eliot Janeway flatly predicts that there will be no British devaluation, no rise in the price of gold and no monetary crisis.

Indicator Digest has, like Dines, Wells and myself, been in the forefront of the "gold buying" school. Indicator has recommended purchase of assorted golds (Kaffirs and Canadians).

Don Worden has been dubious about golds, but in his last letter he concedes: "It doesn't seem likely that pound sterling will be devalued in the very near future, but the possibility exists that such a development could come over the weekend. This undoubtedly would cause a selloff — beyond that, we survive by wits and resourcefulness."

Garfield Drew has not been a "gold-bug," and he has doubted the probability of imminent devaluation.

A. Hamilton Bolton has recognized the gathering gold problem all along, but up to 1965 he had not taken a strong stand on a rise in the price of gold. Then in January, 1965, he wrote: "A year ago we would have said that there was no possibility of such a move. However, there are now some voices in high places who are willing to concede that a world-wide rise in the price of gold might be a solution to the international liquidity problem, provided its effects could be isolated to a great extent from various domestic economies. The recent crisis in sterling is bringing to the fore the probability that the pound is overvalued and one day may have to be devalued."

All this constitutes the background for my long-term advice to subscribers regarding portfolios which should now be moving towards the recommended 85% cash (Treasury bills) and 10% to 15% gold shares. The policy is long term. The gold position is not speculative — it is strictly a hedge. We are not interested in fluctuations or even secondary reactions in the gold group; we are interested in the hedge. Remember, a portfolio with say 10% golds would sustain a minor over-all loss if those golds retreated 20%. But if the price of gold is doubled and the value of the 10% gold portfolio rises say 400% (not impossible), then the total portfolio would show a 40% gain. This is what I mean by a hedge.

Finally, to underscore the fact that our gold position is long term I quote from an April report by John Exter, Senior Vice President, First National City Bank of New York. "Monetary history demonstrates repeatedly that as long as a country continues an expansionary monetary policy, no other measure that the mind of man can conceive will help its payments deficits .... Given the present demand for credit, interest rates can be held down (in the U. S.) only by a continuing monetary expansion, and with continued monetary expansion, we shall have payment deficits which we shall have to meet by selling gold. We cannot indefinitely sell at this price."

These are the fundamentals. The U. S. insists on expanding its money supply, and it insists on holding down interest rates. The U. S. will therefore continue to lose gold. In the face of the current U. S. policy, we are defending ourselves by holding gold shares. If the U. S. reverses its current monetary policy and constricts the money supply while allowing interest rates to rise, the stock market will collapse. We are defending ourself against that possibility by holding a large percentage of cash.

MARKET PHILOSOPHY: The cyclical swings (to extremes) in human sentiment are a constant source of interest to market students. At certain times (for instance, during the 1939-43 period and again during the 1947-52 period) the "normal" attitude is that one should not own common stocks at all and that the proper place for ones money is in the bank or in bonds. The few brokers who were around during those periods well remember the frustration of calling a client, outlining a superb "value" to him such as General Motors on an 8% yield — and then being rebuffed with an argument which goes something like this: "No, I can't see any future in GM at this price, and for that matter I don't see any future in the entire stock market. As far as I'm concerned, the next big event is going to be the post-war depression, and I'll be darned if I want to get locked into something like that."

As a rule, the public is guided by its most recent experience, and since the most recent experience during the aforementioned periods was stagnation in Wall Street, it was small wonder that the public was completely apathetic if not antagonistic toward common stocks. Now the situation has made the complete circle. Not only the most recent experience but the experience of a whole generation has been one of inflation, expanding earnings and rising stock prices. The "normal" place to keep ones money is now in "things" rather than in the bank. One must own stocks, property, inventory, real estate, anything but cash. The consensus is obviously that we are in for "more of the same," and it is patently clear that the public has been conditioned by its experience during the post-World War II period.

In fact, just as the public in the late 1940's was saturated with 10 to 15 years of depression psychology as regards Wall Street, so today's public is steeped in 15 years of boom psychology. As a result, everyone is now consciously or unconsciously "prepared for more growth and inflation." How does one prepare for perpetual inflation? Simply by being "loaned up," by holding debts contracted with cheap dollars and paying off (in a few years or so) with even cheaper dollars. Have a stake in the stock market "which has been going up for 15 years" and never mind cash, we are advised. Besides, the Government has insured the U. S. system against collapse with a hundred agencies and devices. Furthermore, it is now Government "policy" to keep the boom going. How can anything as big as the U. S. Government run into a stone wall?

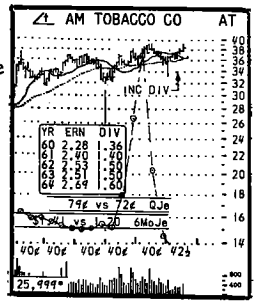
Thus, the psychology of 1949 has been completely reversed, and the normal and accepted thing to do now is to trust in the wisdom of Washington and the soundness of common stocks as a hedge against perpetual inflation. Out of such psychology, if history is any guide, comes shock and disillusionment. For just as night follows day, extremes in confidence give way to doubts, shock, and finally extremes in pessimism. It is my firm belief that we are now passing over the crest of public confidence and heading into a period of doubt. This will be accompanied by a ragged and spotty stock market, and finally by an established (and obvious) major bear trend.

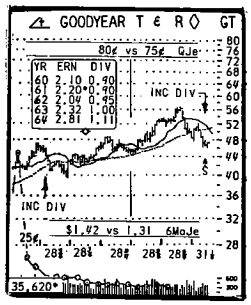
I have been advocating a policy of general liquidation of all tangible assets with the exception of the gold stocks. As a matter of interest, such a policy has (so far) cost my subscribers nothing, for the gold shares during 1965 have appreciated far more than the general market as documented by the relative strength chart of the gold group in the last Letter. Thus, a comparison of the relative merits of holding General Motors or Telephone vs. say President Brand or Dome Mines during 1965 are obvious.

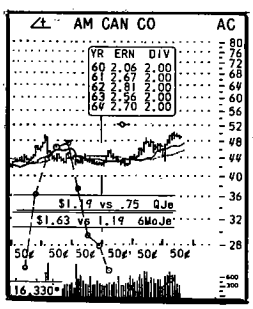
A policy of active liquidation of assets takes nerve and a talent for accepting the probability of change. It requires control over the natural human proclivity (particularly where Wall Street is concerned) to greed. "What about the taxes?" "What if the rally lasts into next December?" "What if the Government keeps the boom going?" "What about Vietnam and massive spending ahead?" These are the questions that everyone is asking, but the true investor is not interested. He is past playing the minor or even the secondary swings. He is thinking in terms of major trouble ahead, and he is thankful for the optimism that remains. In fact, he is utilizing the time provided by this optimism as a golden opportunity to put his investment program in order.

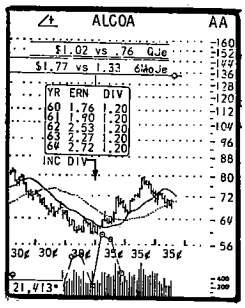
STOCKS: Traders Research lists 46 stock groups in order of relative strength. Top five are now (1) Gold, (2) Sulphur, (3) Airline, (4) Aircraft, (5) Textile. Bottom five are (42) Tobacco, (43) Building supply (44) Cosmetics, (45) Paper, (46) Amusements.

In Letter 294 I listed four stocks which (on the basis of relative strength comparisons) were four of the strongest stocks in the Industrial Average. None had turned bearish during the May-June market weakness. These four stocks were American Can, American Tobacco, Alcoa and Goodyear. How have these four done on the recovery? Can has touched a new high and gained a few points as has Tobacco. Alcoa has been moving sideways, while Goodyear (under pressure of a huge secondary distribution) has done poorly and reversed its relative strength line. A package of all four (see charts) would have just about held even in the market of the past month. Odds for making money — not good. And this is about the way I see it from here on in Wall Street. I consider the odds for beating this market on the upside no better than 50/50 using any selection of stocks picked by whatever means. It is simply too late in the game. Test my opinion; take a selection of choices from any other service and tabulate the net total on points gained in their selections on rallies from here on. Conclusion: Do not be sucked into the vortex of late speculation. If the market turns down from here and losses mount, there are not enough bull arguments to warrant your hanging on to shares purchased in this area.









Charts at right courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas.